29

Tax Savings for Homeowners

Tax on all or a part of a profit from the sale of your home may be avoided or deferred depending on your age.

If you are age 55 or over, you may elect to avoid tax on gain of up to $125,000; *see* ¶29.14.

If you are under age 55 or are age 55 or over and do not want to elect to avoid tax, you may defer tax by buying or building another residence. If you do not meet the deferment tests of ¶29.2, your profit is taxed. If you held the house long-term, the profit is taxable as long-term capital gain.

Where some or all of the sales proceeds will be received after the year of sale and you do not qualify for deferral or elect the exclusion, your gain must be reported on the installment basis, unless you elect to report the entire gain in the year of sale. Installment sales are reported on Form 6252; *see* ¶5.25.

You may not deduct the loss on the sale of a personal residence. Losses on the sale of property devoted to personal use are nondeductible. However, *see* ¶29.12 and ¶29.13, which explain under what conditions you may claim a loss deduction on the sale of a residence which you rent out or inherit.

If you rent out residential property and you or family members also use the residence during the year, rental expenses are subject to the special restrictions discussed at ¶9.7.

Form 1099-S. Sales and exchanges of residences are reported to the IRS on Form 1099-S by the attorney or other party responsible for closing the transaction. The IRS may check your return to verify that you have reported proceeds shown on Form 1099-S.

¶29.1 Checklist of Deductions for Homeowners

You can deduct some of the costs of acquiring and maintaining your principal residence, a second home, or a residence you rent out. The most common deductions are for mortgage interest and real estate taxes. Other expenses are not deductible but are added to basis and thus reduce your taxable gain on a profitable sale of the property.

Here is how you treat the different residence-related expenses for tax purposes:

Closing costs when you buy your house. Most costs incurred in acquiring or buying a home are not immediately deductible, except for mortgage interest and real estate taxes you paid at closing. These are listed in the settlement statement.

The following closing costs are added to the basis of the residence: appraisal fees, attorneys' fees, your payment of back taxes or interest owed by the seller, broker commissions, installation of utilities, recording charges, title searches, abstract fees, and transfer taxes.

Keep careful records of these additions to basis. When you sell the home, they reduce your taxable gain; *see* ¶29.5. The following costs are nondeductible personal expenses which do not increase basis: fire and homeowners insurance premiums, occupancy charges before closing, and sewer and water taxes.

Closing costs incurred when you sell your home reduce the selling price; *see* ¶29.6.

Real estate taxes. You may deduct real estate taxes in the year paid. If you include payment for real estate taxes in your monthly mortgage payment, the portion of your payment allocated to the taxes is deductible only if the bank (or other lender) has paid them over to the taxing authority by the end of the year. The amount you can deduct is shown in the year-end statement from the bank.

Assessments for local benefits. Local assessments for improvements, such as for building sewer or water lines, or new streets or sidewalks, are not deductible but are added to basis.

You may deduct local taxes if they are for repairs or maintenance, rather than for construction of new improvements; *see* ¶16.6.

Improvements and repairs. Repairs are nondeductible personal expenses unless they are allocable to business or rental use of the property; *see* ¶9.4 for rental expenses. The cost of permanent improvements that add to your home's value or prolong its life are added to basis. Examples of permanent improvements to your home include: adding a bedroom, bathroom, deck, swimming pool, or patio to the house; installing a new roof; paving your driveway; or installing new plumbing or wiring.

Casualty losses. Unreimbursed damage to your home from a fire or storm may be deductible as an itemized deduction subject to a $100 reduction and a 10% adjusted gross income floor; *see* ¶18.1. A deductible casualty loss reduces the basis of your home.

Mortgage interest. Interest is deductible on loans up to $1 million for buying, building, or substantially improving your principal residence and one other home. Interest on home equity loans up to $100,000 is also deductible. The $1 million and $100,000 debt limits are cut in half for married persons filing separate returns. *See* Chapter 15 for mortgage interest details.

Points. You may deduct points paid on loans to buy, build, or substantially improve your principal residence in the year of the payment, provided the charges are within the normal range charged in the area under established business practice. Points on any home other than your principal residence must be deducted ratably over the term of the loan.

The IRS and Tax Court do not allow an immediate deduction for points on refinancing a home mortgage unless part of the loan proceeds are used for home improvements. For example, if you use $10,000 of a $100,000 refinancing to make improvements to your principal home, 10% of the points paid are deductible; *see* ¶15.8.

Operating expenses of rental units. If you rent out part of your home, you may deduct on Schedule E expenses allocable to the rental; *see* ¶9.4. Deductions for vacation home rentals may be limited under the rules of ¶9.7.

Home office expenses. If you are self-employed and use a room in your home *exclusively* and on a *regular* basis as either a principal place of business, or a place of business to meet with customers, clients, or patients, you may deduct expenses allocable to the office on Schedule C; *see* ¶40.11. If you are an employee, it is extremely difficult to qualify for a home office deduction; *see* ¶19.13.

Deferring Tax on Gain

¶29.2 Three Tests for Deferring Tax on a Profitable Sale

If you meet the following three tests, you must defer tax (deferral is mandatory) on gain from the sale of your principal residence:

Principal residence test (¶29.3)—requires that you have used your old residence as your principal residence and now use or intend to use your new residence as a principal residence.

Time test (¶29.4)—requires you to buy or build a new residence and use it within two years before or after you sell your old one.

Investment test (¶29.5)—requires you to buy or build a residence at a cost at least equal to the amount you received from the sale of the old residence. If the replacement property costs less, part or all of the gain is taxed.

If you later sell the new residence and meet the three tests, you may defer gain on that sale as well, but only if more than two years have passed since the first sale on which gain was deferred; *see* ¶29.4.

Involuntary conversion of residence. When a residence is condemned by a government authority, a homeowner may elect to treat the condemnation as a sale rather than as an involuntary conversion. Under current law, there is no advantage in making this election, as the involuntary conversion rules allow more time to replace the residence than the rules for deferral; *see* ¶18.21.

The involuntary conversion rules are even more favorable if a principal residence is damaged in a federal disaster area; a four-year replacement period is allowed as discussed at ¶18.21.

Exchanging residences. When you exchange residences, the trade is considered to be a sale of your old house and a purchase of a new house. If you make an even exchange or pay additional cash, there is no tax on the exchange. If you receive cash in addition to the new residence you generally realize taxable gain to the extent of the cash received.

EXAMPLES

1. Your old house cost $158,000. You exchange it for a new house worth $161,000. You also receive $1,000 in cash. Your gain is $4,000 ($162,000 *less* your $158,000 cost). As you reinvest $161,000 in the new house, taxable gain is $1,000. Cost basis of the new house is $158,000 ($161,000 price less the $3,000 nontaxable gain).
2. Your old house cost $158,000. You exchanged it for a new house worth $160,000, and paid an additional $2,000. You have no taxable gain. The cost of your new house is $160,000 (the cost of your old house, $158,000, *plus* the $2,000 cash).

Sale of residence held by a trust. Whether the tax deferral rules apply to a sale of a residence by a trust depends on whether or not the trust is considered the owner of the trust property. If the trust is considered the owner, the tax deferment rules do not apply as the trust cannot qualify as a person who uses the residence.

In the case of a grantor trust, where the grantor is considered the owner of the trust property for tax purposes, tax deferral is allowed on the sale of a house used as the principal residence by the grantor if the trust acquires a new home which is used by the grantor as a principal residence and if the time (¶29.4) and investment (¶29.5) tests are also met.

¶29.3 Principal Residence Test for Deferring Tax

Deferring tax is allowed only on a sale of your principal residence that meets the time test of ¶29.4 and the investment test of ¶29.5. You may not defer tax on the profitable sale of a second house such as a summer cottage. Nor may you defer tax on the sale of a principal residence by buying a summer home; the new home must also be a principal residence.

If you own two homes and you decide to sell your principal residence and move into the second home, the cost basis of the second house is *not* considered in figuring tax deferral unless it was bought during the replacement time period; *see* ¶29.4. However, remodeling and capital improvement expenses made within the replacement period may be counted; *see* the Example below and ¶29.5.

EXAMPLE

The Shaws sold their house and moved into a house bought 10 years earlier. They did not report gain from the sale, claiming that the cost basis of the new residence exceeded the sales price of the old house. They treated as cost the market value of the house as of the date they began using it as a principal residence. They argued that, although they owned it for 10 years, they did not acquire it for purposes of tax deferral until they began using it as a principal residence. The IRS and Tax Court held that only reconstruction expenses paid within the replacement period could be considered costs of purchasing a new residence.

Types of Qualifying Homes

Tax deferment is not restricted to one-family houses. You may defer tax on the sale and purchase of a mobile home, trailer, houseboat, cooperative apartment (tied to stock ownership), and condominium apartment, which you use as a principal residence. For example, in a private letter ruling, the IRS allowed deferral of gain recognized on the conversion of a co-op apartment to a condominium. An investment in a retirement home community does not qualify if you do not receive equity in the property.

Tax deferment also applies to your sale of a multifamily building in which you have an apartment. You may defer tax on gain allocated to your apartment; *see* ¶29.10. Similarly, where you actively use part of your house for business purposes, such as in operating a farm or a store while living in an apartment in the same building, an allocation is required. If, in the year of sale, part of your home was used as an office for which no deduction was allowed, no allocation is required.

If you sell your old house to one buyer and the adjacent land to another buyer, the land sale may be treated as part of the sale of your principal residence and tax on gain is deferred if the other tests are met. However, if the tract of land is substantial, the IRS may attempt to treat the sales as separate transactions. To avoid this possibility where you want to avoid or defer tax on the sale, try to arrange for the sale of the entire property to one buyer who, in turn, may sell the part he or she does not want to the other buyer.

If you sell only part of a lot on which your residence stands, the gain on the sale may not be postponed by reinvesting in a similar lot or by purchasing a residence. Similarly, if you sell the lot and move your house to a new lot, you may not defer gain on the sale of the old lot. The sale is not of the personal residence.

The location of the old and new residences is not relevant. If you buy or build a new home outside the U.S. and begin to use it within the two-year replacement period (¶29.4), the tax deferral rules apply to the gain realized on a sale of a U.S. residence.

Title to both the old and new home must be in your name. If you place title to the new home in someone else's name, the new home does not qualify you for deferral. An exception exists for a married couple who file a consent form; *see* ¶29.8.

Delay in sale of old residence after you move. When you cannot find a buyer and must move, you may face a problem in deferring tax on a later sale of the house. If you have bought a new house, there is the possibility that the sale of the old house may not occur within the time limits of ¶29.4. If you rent a new residence and delay the purchase of a new house until the sale of the old one, you may face this problem: The IRS may charge that, at the time of the sale, you no longer considered the house as your principal residence.

If, as part of a marital separation or divorce arrangement, you move out before the house is sold, the IRS may claim that it was not your principal residence on the date of sale.

Temporary Rentals

You may defer tax if you move into a new home and temporarily rent out your old home while trying to sell it.

You also may defer tax in this case: You buy a new house and rent it before selling your old house that you continue to live in. You later sell your old house and move into the new house.

EXAMPLES

1. An executive left his residence in suburban New York to live in a New York City apartment near his office; he made no efforts to sell his old home for two years until just before he purchased a new home in Virginia. The Tax Court held that he had abandoned the old home as a principal residence. He timed the sale merely to take advantage of the tax deferral. In another case, a serviceman rented his residence over a six-year period until he could sell at a profit. He had refused earlier offers which would have given him a loss. The Tax Court held that he had abandoned his home as a residence.

   In later decisions, the Tax Court commented that these two cases should not be interpreted as laying down a rule of law that an intention not to return to a home is, by itself, an abandonment of the home as a principal residence. Whether a homeowner has abandoned his or her residence is a question of fact. The absence of an intention to return is only one fact for the court to consider.

2. Thomas, between 1974 and 1978, lived in four different homes. One was in Springfield, Illinois, where his publishing business was located, and the other three were in Florida. He tried to defer tax on the sale of the Springfield house. The IRS disallowed the deferral, but Thomas won his case in the Tax Court by showing that in the four years before the sale, he and his family actually lived in the Springfield home more than in any of the Florida residences. The Springfield home was never rented out, its furnishings were not removed, and it was maintained by a full-time housekeeper. Even while living in Florida, Thomas spent substantial time at the Springfield home while there on business. Other Illinois contacts supported Thomas's case. He and his wife filed Illinois tax returns as full-year residents, had only Illinois driver licenses, and contributed to and attended the church in Springfield.

¶29.4 Time Test for Deferring Tax

If you buy or build a new home, you must do so and *begin to use it* within two years before or after you sell your old one. This time test is strictly applied; failure to comply will not be excused for any reason. However, the two-year period is suspended for workers abroad and members of the armed services, as discussed at the end of this section.

Under the rules for involuntary conversions, a four-year replacement period applies to houses destroyed in federal disaster areas; *see* ¶18.2.

A contract to purchase a new home is *not* sufficient to satisfy the time test. A sale is considered to occur at the earlier of the passage of title or the assumption of the benefits and burdens of ownership.

When you build, you must complete construction and occupy the house within the two-year period.

EXAMPLES

1. Bayley sold his house at a profit, started construction on a new house, and elected to defer tax. The new house was not completed before the end of the required time period. A day before the end of the period, Bayley moved some of his furniture into the house but could not live there. The house had no water or sewage connections. He finally moved in two months later. The IRS taxed the gain because the house had not been timely occupied. The Tax Court agreed. Bayley had made the necessary investment but failed to meet the requirement of occupying the house.

2. The Lokans bought land to farm and build a new home. Several months later, they sold their old house at a profit. During construction, they set up a trailer on the property. When one bedroom and a bath in the new house were completed, three children slept in the house; they, plus one other child, slept in the trailer. The house was not fully completed until three years after the sale. The IRS and the Tax Court held that the Lokans did not reside in the new house; the trailer was their principal residence.

Surviving spouse. If a married couple report a sale on a joint return and one spouse dies before a new residence is purchased during the two-year period, the surviving spouse may defer tax on the original sale by making the purchase within the period.

Deferment for Workers Abroad

If your tax home (¶20.6) is outside the United States, the replacement period is suspended while you are abroad. The suspension applies only if your stay abroad began before the end of the two-year replacement period and lasts until you return from abroad or until four years after the sale, whichever occurs first. Your spouse is also protected by the suspension provided that you both used the old home and new home as your principal residence.

Deferment on entering the Armed Forces. If you go on active duty for more than 90 days, the two-year replacement period is suspended while you are in the service. The suspension applies only if your service began before the end of the two-year replacement period. The suspension generally lasts until your discharge, when the balance of the two-year replacement period starts to run again. However, regardless of the length of service, the replacement period ends *four years* after the date of sale. Thus, even if you remain in the service, you must buy and live in your new home no more than four years after you sell your old home.

There is a further extension of the replacement period if you are stationed outside the U.S. on extended duty or have to live in government quarters at a remote site after returning from a tour of duty outside the U.S. The replacement period is suspended while you are at the foreign or remote site plus one year after the last day you were so stationed. However, the replacement period ends on the date which is *eight years* after the sale. If your spouse is in the armed forces and you are not, you are also protected by the suspension if you jointly owned the old home and both you and your spouse used the old home and new home as principal residences. If you divorce or separate during the suspension period, your replacement period starts to run again the day after the divorce or separation is final.

A special rule applies if you served in a combat zone (¶35.4). The replacement period for members of the Armed Forces or nonmilitary support personnel is suspended while in the combat zone or while hospitalized for combat zone injuries (limited to five years of hospitalization in the U.S.) plus an additional 180 days; *see* ¶35.5.

¶29.5 Investment Test for Deferring Tax

To defer tax on the full amount of gain from the sale of your principal residence, you must buy another principal residence within the replacement period (¶29.4), and your investment must equal or exceed the adjusted sales price of your old home.

You first have to figure your *actual gain* on Form 2119 by subtracting *adjusted basis* for the sold house from the *amount realized* on the sale. Then, to determine how much of the actual gain may be deferred, you have to figure the *adjusted sales price* and also the *cost of the new home*. If the cost of the new home equals or exceeds the adjusted sales price, no part of the gain is taxable in the year of sale; that is, 100% of your gain is deferred. If the cost of the new house is less than the adjusted sales price, the difference is generally taxable; *see* Example 1 on the next page. The key terms *adjusted basis*, *amount realized*, *adjusted sales price*, and *cost of the new home* are explained in this section.

Amount realized. This is the selling price of your old house less selling expenses for commissions, advertising, preparing the deed, and other legal and title services. "Points" paid by you as the seller also reduce the selling price. Transfer taxes, stamp taxes, or similar taxes are selling expenses that reduce the amount realized; do not deduct them as taxes on Schedule A.

The selling price includes the amount of the mortgages on the old house, whether the buyer has assumed or bought the property subject to them. If immediately after the sale you discount notes received on a deferred payment contract, include the discounted value of the notes, not the face amounts.

Do not include amounts received for furnishings, such as rugs and furniture, sold with the house. Profit on a sale of furnishings is reported separately; a loss is not deductible.

Adjusted basis. The adjusted basis of the old house is the original cost, including legal and recording fees, transfer taxes, and other settlement costs paid when you bought the house, plus the cost of home improvements. You must reduce this amount by any depreciation or casualty loss deductions, or energy credits claimed in prior years, and also by any deferred gains from prior home sales. If, when you bought the house, the seller paid any of the points on your mortgage, the seller-paid points reduce basis.

Adjusted sales price. This is the amount realized on the sale of the old house *less* fix-up costs spent to make your old house saleable, such as papering, painting, and similar repairs. To qualify as fix-up costs, the work must be done within the 90-day period ending on the day on which the contract to sell is entered into and paid for within 30 days after the sale.

Fix-up costs do not include costs of permanent improvements spent to clinch a sale, such as, for example, installing a new roof or furnace. Such improvements are capital expenditures added to the cost basis of the old house.

Qualifying fix-up costs are taken into account only for purposes of figuring the adjusted sales price. They are not deductible in figuring your actual gain and are not separately deductible on your tax return.

Cost of the new house. You are not required to reinvest the actual cash proceeds of the sale of your old house. You may buy the new house with a small cash payment plus a large mortgage loan. The cost of the new house includes not only cash payments but also any mortgages you assume or take subject to. Also include purchase expenses such as broker's commissions, title search, transfer taxes, and lawyer's fees. Points that you pay on the purchase of a principal residence are generally immediately deductible and not added to basis; *see* ¶15.8.

If the seller paid points, that amount *reduces* the cost basis of the new home.

If you reinvest proceeds in two homes, you may not figure the investment in both houses. You consider only the investment in your new principal residence.

The present value of future land lease payments may not be added to the cost of your new house.

Construction costs. When you build a house, include all costs paid for the land and construction of the house during the two years prior to the sale and two years after the sale. Costs paid after the two-year period are not included even if you have incurred liability for them before the end of the two-year period. However, these costs do become a part of the cost of the new house to figure gain or loss if you later sell it. If you inherit or receive as a gift all or part of a new home, do not count the value of that part in figuring whether you have reinvested your gain on the sale of your old residence. However, you may include costs of reconstructing an inherited house to make it habitable.

Remodeling a vacation home as a permanent residence. A couple, planning to sell their principal home and remodel their vacation home into a permanent residence, asked the IRS if the remodeling costs could be considered as a purchase of a new residence. They planned to add 35% more living space by converting storage space to living areas, putting in a new roof, installing heating and air conditioning systems, and expanding the basement. The IRS answered that the remodeling qualified because of the substantial structural alterations. Furthermore, the remodeling costs were to be paid within the qualifying replacement period discussed at ¶29.4.

The IRS warned that merely adding a tennis court, pool, or new roof would not have qualified for tax deferral. However, once major alterations are made, all improvements, such as the construction of a pool, could be considered part of the total renovation cost.

How Much Gain Can You Defer?

Compare the adjusted sales price with the cost of the new house. If the cost of the new house is the same or greater than the adjusted sales price of the old house, then none of the actual gain is taxed. But if the cost of the new house is less than the adjusted sales price, you are taxed on the difference—but not on more than your actual gain; *see* Example 1 in the next column.

Cost basis of the new home. If your gain is completely or partially deferred, basis of the new home is reduced by the non taxed gain. *See* Example 1 in the next column. Because of this basis reduction rule, deferred gain may eventually be taxed if you later sell the new home and do not replace it. *See* Example 2 in the next column.

EXAMPLES

1. You are under age 55. You plan to sell your house, which has an adjusted basis of $124,500. To make it more attractive to buyers, you paint the outside at a cost of $800 in April 1996. You pay for the painting when the work is finished. In May 1996, you sell the house for $175,000. Brokers' commissions and other selling expenses are $11,500. In October 1996, you buy a new house for $161,000. This is how you compute the amount realized, the adjusted sales price, gain taxable on your 1996 return, and your adjusted basis in the replacement property:

Selling price	$175,000
Less: Selling expenses	11,500
Amount realized	$163,500
Less: Adjusted basis of old house	124,500
Actual gain	$ 39,000
Amount realized	$163,500
Less: Fix-up costs	800
Adjusted sales price	$162,700
Less: Cost of new house	161,000
Taxable gain	$ 1,700

Of the $39,000 gain, $1,700 is taxable in 1996; the balance, $37,300, is not taxable. The cost basis of the new house is reduced by the deferred gain, giving you an adjusted basis of $123,700 ($161,000 – $37,300). The Form 2119 worksheet on the next page shows how gain on the sale and adjusted basis of the new home is figured.

2. Same facts as in Example 1, except that in 1997 you sell the new house for $161,000 and move to a rental apartment. Taxable gain is $37,300:

Selling price	$161,000
Less: Adjusted basis	123,700
Taxable gain	$ 37,300

The exact amount of additional gain would have been taxed on the sale of your old house if you had not bought the second house. In other words, you merely deferred tax on the sale of your first house until you sold the new house without a further replacement.

Cost basis of a cooperative apartment. In addition to the cash paid for the stock in the cooperative, include your share of the cooperative's outstanding mortgage, determined as of the date you purchased the stock if these three tests are met:

Worksheet for Form 2119

Part I Gain on Sale

1	Date your former main home was sold (month, day, year) ▶	1	5 / 12 / 96
2	Have you bought or built a new main home?		☑ Yes ☐ No
3	If any part of either main home was ever rented out or used for business, check here ▶ ☐ and see instructions.		
4	Selling price of home. Do not include personal property items you sold with your home	4	175,000
5	Expense of sale (see instructions)	5	11,500
6	Subtract line 5 from line 4	6	163,500
7	Adjusted basis of home sold (see instructions)	7	124,500
8	Gain on sale. Subtract line 7 from line 6	8	39,000

Is line 8 more than zero?

- Yes → If line 2 is "Yes," you must go to Part II or Part III, whichever applies. If line 2 is "No," go to line 9.
- No → Stop; Attach this form to your return.

9 If you haven't replaced your home, do you plan to do so within the replacement period (see instructions)? ☐ Yes ☐ No

- If line 9 is "Yes," stop here, attach this form to your return, and see **Additional Filing Requirements** on page 1.
- If line 9 is "No," you must go to Part II or Part III, whichever applies.

Part II One-Time Exclusion of Gain for People Age 55 or Older—By completing this part, you are electing to take the one-time exclusion (see instructions). If you are not electing to take the exclusion, go to Part III now.

10	Who was age 55 or older on the date of sale?		☐ You ☐ Your spouse ☐ Both of you
11	Did the person who was 55 or older own and use the property as his or her main home for a total of at least 3 years of the 5-year period before the sale? See instructions for exceptions. If "No," go to Part III now		☐ Yes ☐ No
12	At the time of sale, who owned the home?		☐ You ☐ Your spouse ☐ Both of you
13	Social security number of spouse at the time of sale if you had a different spouse from the one above. If you were not married at the time of sale, enter "None" ▶	13	
14	Exclusion. Enter the smaller of line 8 or $125,000 ($62,500 if married filing separate return). Then, go to line 15	14	

Part III Adjusted Sales Price, Taxable Gain, and Adjusted Basis of New Home

15	If line 14 is blank, enter the amount from line 8. Otherwise, subtract line 14 from line 8	15	39,000
	• If line 15 is zero, stop and attach this form to your return. • If line 15 is more than zero and line 2 is "Yes," go to line 16 now. • If you are reporting this sale on the installment method, stop and see the instructions. • All others, stop and enter the amount from line 15 on Schedule D, col. (g), line 4 or line 12.		
16	Fixing-up expenses (see instructions for time limits)	16	800
17	If line 14 is blank, enter amount from line 16. Otherwise, add lines 14 and 16	17	800
18	Adjusted sales price. Subtract line 17 from line 6	18	162,700
19a	Date you moved into new home ▶ 10 / 17 / 96 b Cost of new home (see instructions)	19b	161,000
20	Subtract line 19b from line 18. If zero or less, enter -0-	20	1,700
21	Taxable gain. Enter the smaller of line 15 or line 20	21	1,700
	• If line 21 is zero, go to line 22 and attach this form to your return. • If you are reporting this sale on the installment method, see the line 15 instructions and go to line 22. • All others, enter the amount from line 21 on Schedule D, col. (g), line 4 or line 12, and go to line 22.		
22	Postponed gain. Subtract line 21 from line 15	22	37,300
23	Adjusted basis of new home. Subtract line 22 from line 19b	23	123,700

1. The mortgage is properly allocated to your apartment. The IRS will accept a mortgage allocation based on the same ratio as your stock interest bears to the total value of all the corporate stock.
2. The corporation retains your stock as a pledge for payment of your annual charges such as interest and principal payments on the mortgage.
3. Your share of corporate assets will be reduced by the unpaid balance of your proportionate share of the mortgage if the corporation is liquidated.

Loss on repayment of foreign mortgage. If you sell a foreign residence at a gain but incur a loss in the repayment of the mortgage because of currency fluctuations, you may not offset the loss against the gain. The loss is not deductible.

¶29.6 Reviewing Purchase and Sales Records

Arrange your records into three groups: (1) records of the purchase costs of the old house and improvements; (2) records of the sale of your old house; and (3) records of the new purchase. These are essential for determining the taxable gain on the sale of the old house and the cost basis for the new house.

Sale of the old house. You should have: (1) the sales contract showing the sales price of the old house; (2) a statement showing settlement costs at the closing and allocating taxes and fire insurance; (3) the bill and record of payment of legal fees; (4) records of payment of brokers' fees, if any; (5) a closing statement from the bank holding the mortgage on your old house showing final interest charges up to the date of transfer of title and prepayment penalties, if any; (6) if you incurred fix-up costs, records of when the work was done and when payment was made; and (7) a record of payments for advertising the sale of the house, if any.

You reduce the selling price of the house by payments for brokers' commissions, legal fees, and advertising expenses. The allocated property taxes are deducted according to the rules at ¶16.8. Mortgage interest and any prepayment penalty are deductible as interest if you itemize deductions. You may not deduct fire insurance premium payments. The treatment of fix-up costs is explained at ¶29.5. The paying off of the principal balance of the mortgage to the bank does not enter into the tax computation

Keep Records for Costs of Old House

Your records here should show the purchase price of the old house plus title insurance fees, recording fees, transfer taxes, and attorneys' fees. Also, keep bills or other records detailing capital improvements made to the house for additional rooms, equipment, landscaping, and similar capital items. The cost of such improvements increases your cost basis for the house and thus reduces taxable gain. If you deducted a casualty loss for damage to the house, the deduction reduces the basis of the house.

Purchase of the new residence. Here you should have (1) your contract showing the cost of the new house plus any additional improvements; and (2) the closing statement showing title insurance fees, adjustment of taxes, mortgage fees, and recording fees.

The cost basis of your new house includes the purchase price (even though all or part is covered by a mortgage), attorneys' fees, mortgage fees, title insurance fees, and recording fees less the gain not taxed on the sale of your old home. Deduct taxes according to the allocation rules at ¶16.8. The payment of fire insurance premiums on the house is not deductible. *See* ¶15.8 for points.

¶29.7 Reporting Residence Sales on Your Return

Report the details of a 1996 sale of a principal residence on Form 2119, which must be attached to Form 1040. On Form 2119, you compute gain or loss on the sale. If you bought another principal residence, you figure whether all of the gain is deferred and also the basis of the new residence on Form 2119. The exclusion for sellers age 55 or over (¶29.14) is also claimed on Form 2119. If your entire gain does not qualify for tax deferral or the exclusion, enter the taxable gain from Form 2119 on Schedule D, or on Form 6252 if you are receiving installment payments over more than one year (¶5.25).

If by the time you file your return you have already purchased a new home, details of the purchase are shown on Form 2119. You qualify for deferral if the cost of the new home equals or exceeds the adjusted sale price of the old home.

If you plan to buy a new home within the two-year replacement period but have not yet done so when you file your 1996 return, you indicate your intention on Form 2119; you may postpone the gain from the sale on your 1996 return. If you later make a timely replacement that qualifies for full deferral (purchase price exceeds adjusted sales price of old home), you should notify the IRS by filing a new Form 2119 for 1996. If the purchase price of a replacement home does not at least equal the adjusted sales price of the old home, or if you do not make a timely replacement, you must file an amended return on Form 1040X to report taxable gain for 1996 and attach a new Form 2119 and Schedule D; you will also owe interest on the tax due. You may also file an amended return to claim a refund if you paid tax on a 1996 gain and later buy a new home within the two-year replacement period.

The IRS may tax you on the unreported gain from the sale of your residence during a three-year period that starts when you notify the IRS on Form 2119 of the cost of your new residence, your intention not to buy one, or your failure to acquire one before the required time limit. In the absence of notice, the IRS may assess the tax on unreported taxable gain at any time.

Federal subsidy recapture*.* If after 1990 your home was financed with the proceeds of a tax-exempt bond or a qualified mortgage credit certificate (¶15.1) and you sell or dispose of the home within nine years of the financing, you may have to recapture the federal subsidy received. Use Form 8828 to figure the amount of the recapture tax, which is reported on Form 1040 as a separate tax.

¶29.8 Deferral for Married and Divorced Couples

If you are married and title to your new house differs from title to your old house, you and your spouse must file a consent statement to defer tax. This situation arises when you or your spouse individually held title to the old house and now you both hold title jointly to the new house, *or* title to the old house was in your joint names and now only one of you holds title to the new house. The consent, signed by both spouses, may be written on Form 2119 or an attached statement. By consenting, you both agree to divide the gain from the old house and to reduce the basis of the new home by the deferred gain. Consents are ineffective to defer tax unless the old and new houses were principal residences of both spouses.

EXAMPLES

1. John Smith holds title to his condominium apartment. Its cost basis is $70,000. He sells the apartment for an adjusted sales price of $80,000 and realizes $10,000 gain. However, within the year, he and his wife, Alice, contribute $40,000 each to buy a new house for $80,000 in their joint names. John pays no tax on the gain if he and Alice file consent statements in which they agree to allocate the basis of the new house between them. They file the consent on Form 2119 or on an attached statement in the year that gain on the sale is realized. John and Alice each have a $35,000 basis in the new house—$80,000 cost, minus $10,000 deferred gain, divided by two.

   If the consent was not filed, John's entire gain of $10,000 would be taxable, since the adjusted sales price of $80,000 exceeded by more than $10,000 his $40,000 share of the cost of the new home; *see* ¶29.5.

2. Same facts as in Example 1 above, except John and Alice jointly owned the condominium, and the new house is bought by Alice alone and placed in her name. Tax on the gain is deferred if both sign a consent statement. The basis of the new house to Alice is $70,000 ($80,000 cost minus $10,000 deferred gain). Without the consent, only Alice would qualify for deferral, since she reinvested in a new home. John, who did not reinvest, would be taxed on his half of the gain from the old house.

Surviving spouses. Consent requirements are deemed satisfied if one spouse dies after the sale of the old home and before a new home is purchased, and if the surviving spouse purchases and occupies a new principal residence within the replacement period.

Couple replacing premarital homes with single home. If you and your spouse sell separate homes owned before marriage, tax on the gain from both sales is postponed if the combined adjusted sales prices of the two sales is reinvested in a new home within the time limit, you each contribute one-half the purchase price, and you take joint title to the new home. No consent statement is required. Report each sale on a separate Form 2119, attached to your joint return.

Separated couples. If you and your spouse sell your jointly owned home, which was used by both of you as your principal residence (¶29.3), and buy and live in separate new homes, you may each be able to defer tax. You each report the sale on Form 2119 as if two separate homes were sold. For example, assume that under state law each of you is entitled to half the proceeds. On Form 2119, you each report half of the sales price. If the cost of your new home exceeds your respective half of the old home's adjusted sales price, you defer tax on your half of the gain. The same deferral test applies to your spouse.

If as a result of a divorce or separation you first move out of your jointly owned home which you later sell, the IRS may bar you from deferring tax on the sale on the ground that it was no longer your principal residence.

Divorce after reporting sale on joint return. If a married couple elect to defer tax on a joint return by indicating on Form 2119 that they plan to buy a replacement residence, and then they are divorced, the home sale deferral rules apply separately to each ex-spouse. If within two years of the sale the wife buys a new home and spends at least her share of the adjusted sales price of the old home (sales price less selling expenses less fix-up costs), she can defer her share of the tax. The same is true for her ex-husband. Each spouse who reinvests should follow the reporting rules in ¶29.7.

However, if one spouse reinvests in a new home within two years and the other does not, the IRS could assess the tax due on the non-deferred portion of the sale proceeds against either spouse. The spouse who *does* reinvest could still be held liable because both spouses are liable for any tax owed on a sale that was originally reported on a joint return. To avoid this possibility, a couple that is contemplating divorce when they sell their home might consider filing separate tax returns in the year of sale. If they file jointly, one option may be to place the sales proceeds in escrow until the replacement period ends, with each spouse's share of any tax due to come from the escrow fund before division of sale proceeds. If the proceeds are divided before a divorce agreement is finalized and one spouse will be paying alimony, a provision in the agreement could note the prospective tax liabilities on the home sale and allow the spouse paying alimony to reduce future alimony payments by any tax liability on the sale that is owed but not paid by the other spouse.

EXAMPLE

A couple reported on their 1983 joint return a $150,000 profit on the sale of their jointly owned home. They did not pay an immediate tax because they indicated on Form 2119 that they anticipated buying a new home within two years. The adjusted sales price of the house was $300,000. They divorced in 1984, and in 1985, the husband bought a new home for $120,000; the wife did not buy a new home within two years. Their divorce agreement provided that each spouse would be responsible for half of any tax due in the event that the taxable gain was not completely deferred. The husband wanted to amend the 1983 joint return in order to report as income the $30,000 difference between the cost of his new home ($120,000) and his half of the adjusted sales price of the old home ($150,000, half of $300,000). The IRS said that he also had to include his wife's $75,000 share of the original gain since he was jointly and severally liable with her for any tax due. He also had to pay interest on the total tax due. To recover the tax payment attributable to his wife's failure to buy a new home within two years he would have to sue her under the divorce agreement. If the wife cannot be located, or refuses to sign the amended joint return, the husband must explain this on the amended joint return.

¶29.9 More Than One Unit Sold in Two Years

Under current law, tax may not be deferred on a home sale if, within two years before the sale, you previously deferred tax on a profitable sale of another principal residence. However, this rule does not apply if you moved to a new job location; *see* Example 2 below.

EXAMPLES

1. In August 1995, you sell your house at a profit and buy a new principal residence with the sale proceeds in the same month. In July 1996, you sell the new residence at a profit and buy another principal residence in September 1996. You may not defer tax on the July 1996 sale because it was within two years of the August 1995 sale. The house purchased in September 1996 is treated as a new principal residence for purposes of postponing tax on the gain on the August 1995 sale.
2. Same facts as in Example 1, but you had to sell your house in July 1996 because of a job relocation to a new city 500 miles away from your prior area of work and residence. Your moving expenses also meet the other tests of ¶21.1. You may defer tax on the sale made in August 1995 and the sale made in July 1996. For deferring tax on the August 1995 sale, you compare the cost of the residence bought in August 1995 with the adjusted sales price of the residence sold in August 1995. To defer tax on the July 1996 sale, compare the cost of the residence bought in September 1996 with the adjusted sales price of the house sold in July 1996.

When you buy a new residence before the sale of the old house and then sell the new house, you may not defer tax on a subsequent sale of the original house, even if all sales and purchases fall within two years. To defer tax on the sale of the original house, you must own the new house at the time of the sale of the old house.

EXAMPLE

You own a house which cost $100,000. In January, you buy another house for $110,000. In July, you sell the house you bought in January for $112,000. In October, you sell your original house for $120,000. You have a $20,000 taxed gain on the October sale. Even though you bought another house within two years before the October sale, you sold that new house before you sold the original house. So you may not avoid tax and have a $2,000 gain on the July sale.

¶29.10 Sale of House Used Partly for Business

If, in the year of sale, you use part of your principal residence for business or rental to tenants, you treat the sale as if you sold two separate pieces of property. You apportion the sales price and basis of the house between the rental portion and the residential portion. The rental portion of basis is reduced by depreciation deductions claimed in prior years for the rental use.

You do not pay tax on gain allocated to your personal use of the house if your reinvestment in a new residence is at least equal to the selling price of the portion of the old house allocated to your personal use. Similarly, if only part of the new property is used as your personal residence, only the cost allocated to that use is considered as reinvested for purposes of deferring tax on gain.

If you have a *loss* on the sale, a loss allocated to rental use is deductible on Form 4797. A loss on the personal part is not deductible, but must be reported to the IRS on Form 2119.

EXAMPLES

1. You sell for $97,000 a three-family house that cost you $33,000. Selling expenses (commissions and legal fees) were $7,000. You lived in one of the apartments. You rented the other two. On the rental part, you took $4,400 of straight-line depreciation. You compute your gain by allocating two-thirds of the selling price and cost to the rental and one-third to the personal part figured as follows:

		Rental	*Personal*
Net sales price ($97,000 – $7,000)		$60,000	$30,000
Cost ($33,000)	$22,000		
Less: Depreciation	4,400	17,600	11,000
Net gain		$42,400	$19,000

You pay tax on the gain of $42,400, which is reported on Form 4797. Only the residential portion is reported on Form

2119. You defer tax on the gain of $19,000 if you invest at least $30,000 in a new residence or you buy a new multifamily house and the cost allocated to your apartment is at least $30,000. If you are age 55 or over, you may elect under ¶29.14 to avoid tax on the personal profit even though you do not make a reinvestment.

2. Same facts as in Example 1, except the net selling price is only $30,000. Here you have a gain of $2,400 ($20,000 – $17,600) on the rental part and a loss of $1,000 on the residential part ($10,000 – $11,000). You may not offset the $1,000 loss against the gain. Each is treated as a separate transaction. The loss is not deductible because it is a personal loss.

Business office in your home. Tax treatment depends on whether or not in the year of sale your home office use qualified for a deduction. If it did, you treat the sale as if you sold two separate properties; allocate the sales price and basis between the space used for the office and residence. The residence portion is reported on Form 2119, the office portion on Form 4797. Gain on the office part is *not* deferrable. If you did not use the office for business in the year of sale or if the office did not qualify for a deduction because it was not used *exclusively* and on a *regular basis* as a principal place of business or place for seeing clients, patients, or customers (¶40.11), a full tax deferral for gain on the sale is allowed. In figuring gain, reduce basis by depreciation claimed for the office in prior years.

Selling Your House at a Loss

¶29.11 No Loss Allowed on Personal Residence

A loss on the sale of your principal residence is not deductible. However, you must still report the sale on Form 2119 and attach it to Form 1040. Do not report the loss transaction on Schedule D. If part of your principal residence was used for business in the year of sale, treat the sale as if two pieces of property were sold; *see* ¶29.10. Report the personal part on Form 2119 and the business part on Form 4797. A loss is deductible only on the business part.

Second home or vacation home. If you sell at a loss a second home or vacation home (not your principal residence) that was used entirely for personal purposes, you report the loss transaction on Schedule D, even though the loss is not deductible. Instead of entering the loss amount in column (f) of Schedule D, write "Personal Loss." If in the year of sale part of the home was rented out or used for business, allocate the sale between the personal part and the rental or business part; report the personal part on Schedule D and the rental or business part on Form 4797.

Losses allowed. A loss may be claimed if you sell a house that has been converted from personal to rental use; *see* ¶29.12. A loss may also be claimed on the sale of a house received as an inheritance or gift if you immediately put it up for sale or rental; *see* ¶29.13.

¶29.12 Loss on Residence Converted to Rental Property

You are not allowed to deduct a loss on the sale of your personal residence. If you convert the house from personal use to rental use you may claim a loss on a sale if the value has declined below the basis fixed for the residence as rental property.

To figure basis for loss purposes, you first need to know the *lower* of (1) your adjusted basis for the house at the time of conversion, and (2) the fair market value at the time of conversion. *Add* to the lower amount the cost of capital improvements made after the conversion, and *subtract* depreciation and casualty loss deductions claimed after the conversion. To deduct a loss, you have to be able to show that this basis exceeds the sales price. For example, if you paid $200,000 for your home and convert it to rental property when the value has declined to $150,000, your conversion date basis for the rental property is $150,000. If the property continues to decline in value, and you sell for $125,000 after having deducted $10,000 for depreciation, you may claim a loss of $15,000 ($140,000 – $125,000). Your loss deduction will not reflect the $50,000 loss occurring before the conversion.

EXAMPLE

In 1987, Adams bought a house in Fort Worth, Texas. He paid $124,000, put in capital improvements and lived there until he was forced to put it on the market when he lost his job. In 1988, he listed the house with a broker for $145,000. After receiving no offers, he decided to lease the house through 1990. By October of 1989 Adams owed $4,551 in property taxes and was three months behind on his mortgage payments. Fearing foreclosure, he sold the house for $130,000.

For purposes of figuring a loss, Adams assumed that the fair market value at the time of conversion was equal to the $145,000 list price. The adjusted basis of the house was $141,026. As this was less than the estimated fair market value of $145,000, he used the $141,026 adjusted basis to figure a loss of $11,026 ($130,000 – $141,026). The IRS claimed the fair market value at the time of conversion was equal to the actual sale price of $130,000. Since basis for the converted property is the lesser of fair market value ($130,000) and adjusted basis ($141,026), Adams had no loss on the sale.

However, the Tax Court allowed a $5,000 loss by fixing the fair market value at the time of conversion at $135,000. It held that Adams sold at a lower price because of his weak financial position of which the buyer took advantage. The court figured the $135,000 as follows: $129,000 fair market value in 1987 (based on an appraisal report, which both parties agree was correct), plus $6,000 of appreciation attributable to the capital improvements made to the property after it was converted.

Profit-making purposes. Renting a residence is a changeover from personal to profit-making purposes. If the house is merely put up for rent or is rented for several months, the IRS may not recognize the house as rental property and disallow the loss deduction. However, the Tax Court has approved a loss deduction where a house was rented on a 90-day lease with an option to buy. The court set down the following two tests for determining when a house is converted to rental property: (1) the rental charge returns a profit; and (2) the lease prevents you from using or reoccupying the house during the lease period. Under the Tax Court approach, you have a conversion to rental property if you have a lease that gives possession of the house to the tenant during the lease period, and if the rent, after deducting taxes, interest, insurance, repairs, depreciation, and other charges, returns you a profit.

Loss allowed on house bought for resale. A loss deduction is also allowed where you acquired the house as an investment with the intention of selling it at a profit, even though you occupied it incidentally as a residence prior to sale. For example, an owner bought a house with the intention of selling it. He lived in it for six years, but during that period it was for sale. He was allowed to deduct the loss on its sale by proving he lived in it to protect it from vandalism and to keep it in good condition so that it would attract possible buyers.

In another case, an architect and builder built a house and offered it for sale through an agent and advertisements. He had a home and no intention to occupy the new house. On a realtor's advice, he moved into the house to make it more saleable. Ten months later, he sold the house at a loss of $4,065 and promptly moved out. The loss was allowed on proof that his main purpose in building and occupying the house was to realize a profit by a sale; the residential use was incidental.

Gain on rented residence. You have a gain on the sale of rental property if you sell for more than your adjusted basis at the time of conversion, plus subsequent capital improvements, and minus depreciation and casualty loss deductions. The sale is subject to the rules of Chapter 44 for depreciable property.

CAUTION

Temporary Rental Before Sale

A rental loss may be barred on a temporary rental before sale. The IRS and Tax Court held that where a principal residence was rented for several months while being offered for sale, the rental did not convert the home to rental property. Tax on a profitable sale could be deferred if a replacement home was purchased (¶29.5), but deductions for rental expenses were limited to rental income; no loss could be claimed. A federal appeals court disagreed and allowed both tax deferral and a rental loss deduction; also *see* ¶9.7.

Stock in cooperative apartment. Normally, you get no deduction for a loss on the sale of your stock in a cooperative housing corporation. It makes no difference that you occasionally sublet your apartment. It is still not considered property used in a business. But you may get a loss deduction when there were non-stockholder tenants in the cooperative housing corporation when you bought your stock. Then, you get a partial capital loss deduction if you sell your stock or if it becomes worthless. To figure capital loss—

First find the difference between your cost and your selling price. This would ordinarily be your capital loss. Then find the percentage of non-stockholding tenants (based on rental values) in the housing corporation when you bought your stock.

Apply this percentage to the loss you figured above. This is the capital loss you are allowed.

See ¶9.5 for when depreciation may be taken on the basis of the cooperative stock ownership.

Partially rented home. You may deduct a loss on a home sale if you rented part and occupied part for your own purposes. A loss on a sale is allowable on the rented portion. You report the sale as if two properties were sold. The residential part is reported on Form 2119 and the rental part on Form 4797.

¶29.13 Loss on Residence Acquired by Gift or Inheritance

You may deduct a loss on the sale of a house received as an inheritance or gift if you personally did not use it and offered it for sale or rental immediately or within a few weeks after acquisition.

If you inherit a residence in which you do not intend to live, it may be advisable to put it up for rent for an ordinary loss deduction. If you merely try to sell, and you finally do so at a loss, you are limited to a capital loss.

EXAMPLES

1. A couple owned a winter vacation home in Florida. When the husband died, his wife immediately put the house up for sale and never lived in it. It was sold at a loss. The IRS disallowed the capital loss deduction, claiming it was personal and nondeductible. The wife argued that her case was no different from the case of an heir inheriting and selling a home, since at the death of her husband her interest in the property was increased. The court agreed with her reasoning and allowed the capital loss deduction.
2. A widow inherited a house owned by her late husband and rented out by his estate. Shortly after getting title to the house, she sold it at a loss which she deducted as an ordinary loss. The IRS limited her to a capital loss deduction. The Tax Court agreed. She could not show any business activity. She did not negotiate the lease with the tenant who was in the house when she received title. She never arranged any maintenance or repairs for the building. Moreover, she sold the property shortly after receiving title, which indicates she viewed the house as investment, not rental, property.

$125,000 Exclusion for Homesellers Age 55 or Over

¶29.14 Qualifying for the Exclusion

If you are 55 years of age or older and sell or exchange your principal residence at a profit, you may avoid tax on profits up to $125,000 ($62,500 for married persons filing separately). To claim this exclusion, you must (1) elect to avoid tax on Form 2119; (2) be age 55 or over on the date of sale; and (3) have owned and occupied the house as your principal residence for at least three of the five years ending on the day of sale. The age, ownership, and use tests are discussed in the next column. The election may be claimed only once with one exception: If you excluded gain under prior-law rules for sales before July 27, 1978, you may make an election under current law.

The election applies to cooperative apartment ownership tied to stock ownership and to condominiums. It also applies to gain realized from an involuntary conversion of your home through fire, storm, or other casualty, or condemnation. Although you avoid tax on gain, you consider the gain as gross income in determining whether you are required to file a return.

The election to exclude gain does not apply where only a partial interest in the home is sold. In a private letter ruling, the IRS refused to permit an exclusion to a homeowner who sold the remainder interest in her home while retaining the right to live in it for life. However, the exclusion is allowed if a homeowner gives away a remainder interest in the house and then sells the retained life interest. The exclusion may be claimed because the life interest is the owner's entire interest in the residence.

Age test. You must be age 55 or over by the date of sale. It is not sufficient that you will be age 55 sometime during the year in which the sale occurs. A sale on the date of your 55th birthday qualifies.

If you receive an offer that you want to accept before your 55th birthday, contract to sell but do not give title or possession until you are age 55 if you want to make the election. A sale may be considered to have occurred for tax purposes when you give the buyer possession of the house, although you have not formally passed title.

The use and ownership test. You must have owned *and* occupied your home as your principal residence for at least three out of the five years ending on the date of sale. Ownership and use for 36 full months or for 1,095 days (365 × 3) during the five-year period qualifies. The three years need not be consecutive, and the periods of use and ownership may be different. Short, temporary absences for vacations are counted as periods of use, even if the house is rented while you are away.

However, if you are away from the house for a more substantial period, such as a job transfer or sabbatical lasting a year or more, the IRS will not treat that period as your use of the home.

CAUTION Rentals in Five-Year Period

Rental of the house while you are away on vacation or other seasonal absences during the five-year period preceding the date of sale will not disqualify the election. Where you rent your house for longer periods and you want to avail yourself of the tax-free election, make sure that a rental during the five-year period does not exceed two years. If it does, the three-year residence test will not be met.

Disabled owners. If an illness requires an owner to move to a licensed nursing home or similar state- or city-licensed facility because of mental or physical disability, the period in the facility may be counted as "use" of the residence as long as the person owned and used the residence for at least one year during the five-year period preceding the sale.

EXAMPLES

1. You are over age 55. You bought your principal residence in 1973. On January 1, 1995, you move to another state and rent the house. On July 1, 1996, you sell it. You may elect tax-free gain. You owned and used the house as your principal residence for three out of the five years preceding the sale.
2. You are age 62 and have lived with your son and daughter-in-law since 1988. Your son owned the house until you bought it from him in January 1994. You sell it on March 31, 1996. You may not elect the exclusion in 1996. Although you used the property as your principal residence for more than three years, you did not own it for three of the five years preceding the date of the sale.
3. On January 1, 1993, a teacher, age 55, bought and moved into a house which he used as his principal residence. On February 1, 1995, he went abroad on a one-year sabbatical and, during part of the year, leased the house. On March 1, 1996, one month after his return, he sold the house. He may not elect the exclusion. He did not use the residence for the required three years. Under IRS regulations, his one-year leave is not considered a temporary absence that may be counted as part of the three-year occupancy period.

Jointly owned residences. If you are married on the date of sale and the home is owned jointly with your spouse, only one of you must meet the age, use, and ownership tests to claim the exclusion on a joint return for the year of sale.

If a home is not jointly owned, the spouse owning the home must meet the age, ownership, and use tests. If you hold title but are under age 55, filing a joint return with a spouse over age 55 who does not have title will not qualify you for the exclusion because neither spouse meets all three tests. Similarly, a spouse under age 55 with full title may not qualify for an immediate exclusion by putting the house in joint names; you must still wait three years before selling. This is because a spouse over age 55 who has lived in the home at least *three* years must also have the ownership interest for at least three of the five years before the sale.

If you are married at the time of sale, both spouses must consent to an election of the exclusion, and an election bars either of you from claiming the exclusion again. *See* ¶29.15 for these and other election rules for married couples.

Joint ownership with someone other than spouse. A husband and wife selling a jointly owned residence are considered as one taxpayer for purposes of the exclusion limitation. But if joint owners are not married, each owner who meets the tests for age (55), use (principal residence), and holding period (three of five years) may exclude gain up to $125,000 on his or her interest in the residence. The fact that one owner meets the requirements does not qualify the other for the exclusion.

CAUTION

Part of Home Used for Business

Partial business use of your residence during the five-year period preceding the sale may affect the amount of the exclusion. If you used *part* of your residence for business purposes, for example as a home office, for more than two years during the five-year period preceding the sale, the exclusion does not apply to the gain allocated to that business part of the home. If business use was two years or less, business use is ignored in figuring the exclusion.

¶29.15 The Exclusion and Married Couples

If you are married at the time of the sale and the home is jointly owned, one of you must meet all three tests for the exclusion—age, use, and ownership. If only one of you holds title, that person must meet all the tests. Regardless of who owned the home, both of you must agree to elect the exclusion. Under the one lifetime election rule, neither of you may claim the $125,000 exclusion again; *see* the Caution in the next column.

A married person who files a separate return may exclude up to $62,500 of profit, provided the other spouse consents to the election on Form 2119 or in an attached statement. By so consenting, the other spouse is barred from electing the exclusion for a future sale.

If you later decide to revoke the election, you also must have your spouse's consent. If you are divorced after the election but then want to revoke, you must get your former spouse's consent to the revocation. A revocation is made in a signed statement showing (1) your name and Social Security number; (2) the year in which the election was made and filed; and (3) the Internal Revenue office where you filed the election. Attach the revocation to an amended return (Form 1040X) and amended Form 2119.

CAUTION

Election Applies to Both Spouses

Only one lifetime election is allowed to a married couple; you and your spouse do not each have a separate election to claim the exclusion. If either you or your spouse has previously elected the exclusion, neither of you may make another election. If spouses make an election during marriage and later divorce, no further elections are available to either of them or to either of their new spouses if they remarry.

Sales before marriage. What if before your marriage you and your spouse each owned and used a separate residence, and after your marriage both residences are sold? May two elections be made? No. An election may be made for a sale of either residence (but not for both residences) provided the age, ownership, and use requirements are met. To take advantage of two exclusions, the sales should take place before marriage; *see* Example 1 below.

If an election is made before the marriage and the electing spouse dies, the survivor may be free to make the election; *see* Example 2 on the next page.

EXAMPLES

1. A woman, age 56, plans to marry at the end of 1996. She also plans to sell her home at a substantial profit. Her fiance sold his home at a profit of $100,000 in August 1994 and elected on his 1994 return to avoid tax. If she sells the house before the marriage, she may claim the exclusion on a 1996 joint return or separate return. True, only one lifetime election of the exclusion is allowed to a married couple, but for purposes of this test, marital status is determined at the time of sale. Thus, if she sells before she marries, her right to claim the election is not affected by her spouse's prior election. However, if she sells after the marriage, she may not claim the $125,000 exclusion because of her spouse's 1994 election. Once married, the right to claim the election on a sale of her home is forfeited because of her spouse's prior election, even though the spouse's home sale may have taken place prior to their marriage.

2. John and Mary, both over age 55, planned to marry and to live in Mary's home. Before the wedding, John sold his residence and elected to avoid tax on the sale of his house. A few years later, John died and Mary sold her house and elected to avoid tax on the sale. The IRS allowed the election. Since John's sale was made before they married, his election did not affect her right to make an election after his death.

If John had not died and the couple had sold Mary's house, the election would not have been allowed. John's prior election would have barred Mary from making the election.

Death of spouse. A surviving spouse who inherits a residence upon the death of his or her spouse may be able to qualify for an exclusion even before three-out-of-five-year ownership and use tests are satisfied. The surviving spouse is treated as meeting the ownership and use tests and may elect the exclusion on a sale after reaching age 55, provided (1) he or she has not remarried as of the date of the sale; and (2) the deceased spouse met the ownership and use tests and had not previously elected the exclusion or consented to a former spouse's exclusion on a sale after July 26, 1978.

If you are married on the date of sale and your spouse dies after the sale but before you could make an election, your deceased spouse's personal representative (administrator or executor) must join with you in making an election. Similarly, the personal representative must join in a revocation of any election previously made by you and your deceased spouse. Joint elections and revocations are required, even though the residence was separately owned, separate tax returns are filed, or the non-owning spouse does not meet the three-year residence requirement.

In one case, the IRS permitted an election by an executor where a sale was completed after the death of the owner under an executory contract made by the owner prior to his death.

Sale by irrevocable trust. Where a residence is transferred to an irrevocable trust by a married couple, whether they can claim the exclusion on a sale by the trust depends on whether they are treated as the owners of the trust for tax purposes. The IRS in a private ruling held that if they are treated as owners under the grantor trust rules because of retained powers over the property, they may claim the exclusion if they meet the age, ownership, and use tests.

Sale by marital trust for surviving spouse. Property may be left to a marital trust for the benefit of a surviving spouse if there is concern that the survivor may be unable to manage the property. A personal residence may be put into the trust. If the surviving spouse is entitled to all the trust income and has an unlimited power to receive trust corpus upon request or appoint the property to any other person, the surviving spouse is considered the owner of the trust for tax purposes. If the trust sells the personal residence, the surviving spouse can elect to claim the $125,000 home sale exclusion, provided he or she is over age 55 on the date of sale and has (1) owned (through the trust) and used the residence as a principal residence for three of the last five years preceding the date of sale; and (2) the $125,000 exclusion was not previously elected by the surviving spouse or the deceased spouse with respect to a prior sale.

¶29.16 How To Claim the Exclusion

If you meet the tests at ¶29.14, you elect the exclusion on Form 2119 or in a signed statement which you attach to your income tax return for the year of sale. If you do not have Form 2119, write on a separate statement that you elect to exclude from income the gain realized on the sale. In addition, give the following data: (1) your name, age, Social Security number, and marital status as of the date of sale; (2) the dates you bought and sold your residence; (3) the adjusted sale price and the adjusted basis of the property on the date of sale; and (4) the length of any absences during the five years preceding the sale, apart from vacations and other seasonal absences.

If you were married at the time of sale, both you and your spouse must agree to elect the exclusion, and an election bars either of you from claiming the exclusion again; *see* ¶29.15.

Changing an exclusion decision. The tax-free exclusion is available to you only once in your lifetime. If, at the time you sell your home, you plan to invest the money in another home of sufficient cost to completely defer tax but later change your plans, you can make the election at any time before the end of the period for making a refund claim for the year in which the sale occurred. This is generally within three years from the due date of the return filed for the year of the sale. Similarly, if you make the election and then decide to revoke it, you may do so within the same three-year period.

When Election May Be Inadvisable

If you sell your principal residence at a gain which is substantially less than the maximum $125,000 exclusion, and you plan to reinvest at least all of the net proceeds from the sale in a new home, consider deferring tax rather than electing to exclude gain. You are permitted only one lifetime exclusion. For example, if you have a gain of $10,000 and elect to exclude it, you have used up your once-in-a-lifetime election; a later home sale will not be entitled to a $115,000 exclusion. If you buy a new house at a cost at least equal to the adjusted sales price of the old home and you do not elect the exclusion, the entire gain from the sale of your old home is deferred; *see* ¶29.5. If and when you sell the new house without a further home purchase, the election to exclude gain may then be made.

Worksheet for Form 2119

Part I Gain on Sale

1	Date your former main home was sold (month, day, year) ▶	1	7 / 19 / 96
2	Have you bought or built a new main home? ☐ Yes ☐ No		
3	If any part of either main home was ever rented out or used for business, check here ▶ ☐ and see instructions		
4	Selling price of home. Do not include personal property items you sold with your home	4	192,000
5	Expense of sale (see instructions)	5	12,000
6	Subtract line 5 from line 4	6	180,000
7	Adjusted basis of home sold (see instructions)	7	40,000
8	**Gain on sale.** Subtract line 7 from line 6	8	140,000

Is line 8 more than zero?
- Yes ▶ If line 2 is "Yes," you must go to Part II or Part III, whichever applies. If line 2 is "No," go to line 9.
- No ▶ **Stop. Attach this form to your return.**

9 If you haven't replaced your home, do you plan to do so within the **replacement period** (see instructions)? ☐ Yes ☐ No
- If line 9 is "Yes," stop here, attach this form to your return, and see **Additional Filing Requirements** on page 1.
- If line 9 is "No," you must go to Part II or Part III, whichever applies.

Part II One-Time Exclusion of Gain for People Age 55 or Older—By completing this part, you are electing to take the one-time exclusion (see instructions). If you are not electing to take the exclusion, go to Part III now.

10	Who was age 55 or older on the date of sale? ☐ You ☐ Your spouse ☑ Both of you		
11	Did the person who was 55 or older own and use the property as his or her main home for a total of at least 3 years of the 5-year period before the sale? See instructions for exceptions. If "No," go to Part III now ☑ Yes ☐ No		
12	At the time of sale, who owned the home? ☐ You ☐ Your spouse ☑ Both of you		
13	Social security number of spouse at the time of sale if you had a different spouse from the one above. If you were not married at the time of sale, enter "None" ▶	13	
14	**Exclusion.** Enter the **smaller** of line 8 or $125,000 ($62,500 if married filing separate return). Then, go to line 15	14	125,000

Part III Adjusted Sales Price, Taxable Gain, and Adjusted Basis of New Home

15	If line 14 is blank, enter the amount from line 8. Otherwise, subtract line 14 from line 8	15	15,000
	• If line 15 is zero, stop and attach this form to your return. • If line 15 is more than zero and line 2 is "Yes," go to line 16 now. • If you are reporting this sale on the installment method, stop and see the instructions. • All others, stop and enter **the amount from line 15 on Schedule D, col. (g), line 4 or line 12.**		
16	Fixing-up expenses (see instructions for time limits)	16	2,000
17	If line 14 is blank, enter amount from line 16. Otherwise, add lines 14 and 16	17	127,000
18	**Adjusted sales price.** Subtract line 17 from line 6	18	53,000
19a	Date you moved into new home ▶ 8 / 7 / 96 b Cost of new home (see instructions)	19b	50,000
20	Subtract line 19b from line 18. If zero or less, enter -0-	20	3,000
21	**Taxable gain.** Enter the **smaller** of line 15 or line 20	21	3,000
	• If line 21 is zero, go to line 22 and attach this form to your return. • If you are reporting this sale on the installment method, see the line 15 instructions and go to line 22. • All others, enter **the amount from line 21 on Schedule D, col. (g), line 4 or line 12**, and go to line 22.		
22	Postponed gain. Subtract line 21 from line 15	22	12,000
23	**Adjusted basis of new home.** Subtract line 22 from line 19b	23	38,000

¶29.17 Combining the Exclusion With Tax Deferral

If you sell your principal residence at a gain of over $125,000 and plan to purchase a new home, you may take advantage of the exclusion and also the tax-free deferral rules. Where you qualify for the exclusion (¶29.14), your gain up to $125,000 is tax free. You may then defer all or part of the remaining gain, depending on the amount of your investment in the new home. You may defer all of the remaining gain by making an investment at least equal to the adjusted sales price of the old house (sales price less selling expenses and fix-up costs; *see* ¶29.5) less the tax-free gain. If you invest less than this amount, the difference between (1) the adjusted sales price of the old house less the tax-free gain, and (2) the new investment is taxed, but not exceeding the remaining gain.

In determining whether you have to file a return, the tax-free gain realized from the sale of your house is counted as gross income, although not taxed.

The following Example, which is keyed to the Form 2119 Worksheet on page 420, shows you how the exclusion (¶¶29.14–29.16) is combined with the tax deferral (¶¶29.2–29.10).

EXAMPLE

You and your spouse are both over age 55. You sell your jointly owned home, which you have lived in since 1951. The selling price is $192,000, and you have selling expenses of $12,000. You also have fix-up costs (¶29.5) of $2,000. Adjusted basis of the house is $40,000. Your profit is $140,000 ($180,000 – $40,000). You elect to exclude $125,000 of the profit from tax. You may still defer all of the remaining profit of $15,000 of gain by investing in a new home which costs at least $53,000.

Amount realized ($192,000 – $12,000)	$180,000
Less: Fix-up costs	2,000
Adjusted sales price	$178,000
Less: Excluded gain	125,000
Revised adjusted sales price	$ 53,000

If you buy a new residence for $50,000, $12,000 of the remaining gain is deferred and $3,000 of the gain is taxable ($53,000 – $50,000). Basis for the new residence is reduced by the deferred gain; thus, basis here would be $38,000 ($50,000 cost less $12,000 deferred gain). *See* the sample Form 2119 on the preceding page.

Selling on the installment method. Where you sell your home and take a purchase money mortgage, you have made an installment sale (¶5.25). Only a portion of each payment is taxable where you do not reinvest in a new home qualifying for deferral. You must use Form 6252 to report gain on the installment basis.

EXAMPLE

Smith sold his home, which cost $140,000, for $300,000 and elects the exclusion. The buyer is unable to get outside financing so Smith agrees to take back a purchase money mortgage of $150,000, payable over 15 years with 10% interest. Of the $160,000 profit ($300,000 – $140,000), only $35,000 is taxable; $125,000 is tax free. The $35,000 gain is reported over the 15 years in which payment on the mortgage loan is received. To determine the amount of each payment taxable as income, the gross profit ratio is applied to each payment actually received. On Form 6252, the gross profit ratio is figured by dividing the taxable gain by the total contract price. Here, this is $35,000 divided by $300,000, which gives a profit ratio of 11.66%. Thus, in the year of sale, $17,490 (11.66% × $150,000 down payment) is taxable. Of each annual $10,000 installment over the 15 years, $1,166 is taxable ($10,000 × 11.66%).